any losses can be recovered through the cost-of-service showings, smaller systems are clearly treated disparately by the FAS 51 standard.

4. Continuing Construction Does Not Recommence the FAS 51 Prematurity Period.

Another disadvantage of smaller operators is that because of capital attraction difficulties, they typically build their systems in phases. The FAS 51 prematurity period does not recommence with each new phase of construction[41]. Consequently, an operator who takes more time to build new plant is penalized under the Commission's methodology.

C. Operators Must Be Allowed To Recover All Prior Losses.

Cable operators, at least smaller operators, must be entitled to include all legitimate prior year accounting losses in the ratebase. To exclude such items violates the express mandate of Congress which requires the permitted rate to allow for a "reasonable profit." This term cannot simply be viewed in isolation to apply to a particular year. It must be considered in the long-term. To not allow recovery of prior year losses, is to violate the principles of the investment cycle theory that the Commission was so enamored with in the NPRM.

D. The Commission Must Allow Inclusion of Unrecovered Losses In The Rate Base.

The losses incurred by smaller operators are real and recognized by Generally Accepted Accounting Principles. They must be recovered. They simply cannot be ignored without threatening the financial viability of smaller cable operators. The Commission has

[41]The prematurity period may only recommence if a number of factors are satisfied. For example, the system cannot be geographically contiguous and there must be mechanical differences between systems (i.e., different headends).

clearly stated that "we are guided by our belief that consumer welfare is best served by financially sound cable operators."[42]

The Commission can also not assume that inclusion of the losses will result in harm to the subscribers. They simply will not. The Commission expresses concern that operators can manipulate the ratebase through use of accelerated depreciation. Not so. Any early year losses due to accelerated depreciation will be offset by decreases in the ratebase over time. The danger of manipulation in this manner is minimal when one considers that the Commission has reserved the right to review depreciation computations.

Blanket exclusion of losses especially harms smaller operators who build their systems in phases. These operators have multiple start-up periods for major system expansions which are not recognized under FAS 51. Nevertheless, losses which represent ordinary and necessary expenses are presumptively excluded from the ratebase.

Losses in the initial years of operation are in many cases akin to capital contributions by equity investors. It represents capital that was put into and retained by the entity, only to be paid out at a future time. For these same reasons, the losses must also be allowed to be amortized over the remaining life of the franchise.

E. Requiring Comparability To Competitive Systems Is An Inappropriate Standard.

The Commission requires operators to submit detailed evidence of the effect the amortization period has on rates in comparison to rates of similar systems which are subject

[42] *Second Reconsideration Order* at ¶32.

to competition.[43] The Commission's introduction of a comparable rate standard in this case is inappropriate. The only factor the Commission should evaluate in a cost-of-service showing is the *bona fide* cost of providing service. If the Commission really believes what it says about the importance of financially sound cable operators, it must allow recovery of all prior year losses in future years.

V. ACQUISITION INTANGIBLES AND STEPPED-UP BASIS IN TANGIBLE ASSETS MUST BE INCLUDABLE IN THE RATEBASE.

A. The Commission's Across-The-Board Disallowance Of Acquisition Intangibles Is Unwarranted.

The Commission disallowed from inclusion in the ratebase most intangibles recorded as the result of a system acquisition[44]. Such treatment is unjustifiably harsh.

The Commission was charged with a "balancing" act between the needs of cable operators and their subscribers. It has not balanced these interests, however. Rather, a bleak future has been handed to smaller operators. These operators who purchased systems, many times in rural America, paid for intangibles typically found in operational cable systems. Even more often, they borrowed the money to buy the system. These operators now have two choices under the Commission's methodology: (1) bankruptcy; or (2) bankruptcy.

The complete disallowance of these purchase costs for smaller operators without any ability to cross-subsidize operations amounts to nothing less than a forced sale of the cable system -- a sale to the lender.

---

[43] Report and Order at footnote 134.

[44] *See*, i.e., *Report and Order* at ¶¶85-89.

B. The Commission's Premise That Monopolistic Profits Existed Throughout The Industry Is Unsupported.

The Commission's assertions that acquisition intangibles represent either the ability to earn monopolistic profits or the ability to provide extensive unregulated activities.[45] No evidence exists on the record that smaller operators and smaller systems have been earning profits at monopolistic levels. In fact, the evidence on the record suggests the opposite.[46]

An examination of many rural areas served by cable also refutes the presumption that monopolistic profits existed. Many rural cable operators service areas with fewer than 2,500 inhabitants -- areas where the telco/cable cross-ownership ban does not apply. Subsequent to the 1984 Cable Act, the local exchange carriers could have built these areas, but chose not to. If these areas were prime for earning monopolistic profits, why then was there not a stampede to build cable in these areas, especially by the local exchange carriers? It was not until the smaller operators built those areas primarily during the late 1980's that they received cable service. The lack of interest in serving these areas provides strong evidence that monopoly profits did not exist.

C. All Acquisition Intangibles Should Be Includable Pending Completion Of The Commission's Cost Studies.

In its general rate regulation docket,[47] the Commission has determined that full reduction rates not be implemented currently for certain smaller operators and systems

[45] *Report and Order* at ¶¶91 - 92.

[46] *Second Order On Reconsideration*, MM Docket 92-266 at ¶120, in which the Commission acknowledged that smaller operators and systems might have higher operating costs.

[47] MM Docket 92-266.

because they might not have the financial wherewithal to absorb rate rollbacks and they might not be earning the same level of profitability as other operators.[48] The same principal must apply in the instant proceeding.

The disallowance of all acquisition costs under the premise of eliminating monopolistic rates is the same as requiring a smaller operator or system to adopt full reduction rates currently. The Commission must create parity between rate regulation methods. It is even more important to establish regulatory parity given that cost-of-service is the safety net methodology, yet an important concept from the benchmark/full reduction methodology has not been carried over. Consequently, cost-of-service is again compromised as the ultimate safety net.

D. The Commission Must Change Its Presumptions To Allow Inclusion Of Acquisition Intangibles At Least On An Interim Basis.

As stated earlier in these Reply Comments, it is not sufficient to permit operators to overcome the Commission's presumptions on an individual case basis. The Commission's presumptions are simply too difficult to overcome and it unfairly places significant burdens on smaller operators. This is not the way that Congress envisioned the imposition of rate regulation on smaller operators.

VI. CONCLUSION

The Commission must ensure that the cost-of-service methodology provide a realistic safety net for smaller operators and systems. It currently does not because of the presumptive disallowance of acquisition intangibles and prior year losses. Furthermore, the

[48] *Second Order On Reconsideration*, MM Docket 92-266, Released March 30, 1994, at ¶120.

wholly inadequate rate of return understates requisite levels of profitability. Changes must be made immediately, at least on an interim basis.

Respectfully submitted,

SMALL CABLE BUSINESS ASSOCIATION

By: ______________________________

Eric E. Breisach
HOWARD & HOWARD
107 W. Michigan Ave., Suite 400
Kalamazoo, Michigan 49007
Attorneys for the Small Cable Business Association

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Paine Webber Cost
of Equity Analysis

Research

PaineWebber Incorporated
1285 Avenue of the Americas
New York, NY 10019
212 713-2420
212 713-1075

Christopher P. Dixon
Senior Vice President

RECEIVED
JUL 1 1 1994

VIA TELEFAX

PaineWebber

July 6, 1994

Mr. Eric E. Breisach
Howard & Howard
The Kalamazoo Building, Suite 400
107 West Michigan Avenue
Kalamazoo, MI 49007-3956

Dear Mr. Breisach:

As you requested, the following outlines one approach to evaluating the expected return on equity as represented in market prices for cable stocks over the past several years. The model was developed during the post-HLT period to quantify anticipated equity returns due to the combined effect of cash flow growth and capital structure, and makes use of the methodology developed in the Dupont model.

The basis premise is as follows. Equity returns will be driven by expected growth rates in cash flow or by capital structures. High returns can be generated through operating leverage, financial leverage or a combination thereof.

By way of example and as shown in the exhibit, if the company is capitalized at 50% debt, if cash flow grows at 10 percent and if the market values the total enterprise at 8 times cash flow in year seven (with no multiple expansion,) an equity investor who purchases equity when the market values the total enterprise at 8 times will receive an annual compounded return on equity of 24%. Cash flow growth captures the operating leverage and the initial debt to capital ratio captures financial leverage.

Note that the model does not assume the addition of debt and so actually understates the expected equity return as the debt to capital ratio will decline over time as the equity account grows. This method also assumes that five percent of each year's net income will be reinvested in working capital. Viewed another way, the equity return is based upon a dividend discount with a 95% payout with that payout reinvested in cable plant and so reflected in the equity account.

For cable companies, leverage is particularly important as a 50% capital structure is conservative. Thus, the debt-laden structures of the eighties led investors to typically expect equity returns above 25%. For early stage, smaller companies with higher risk, expected return on equity often exceeded 30%.

Stated differently, this meant that few investors were willing to invest equity capital into the industry unless they could realize equity returns above 25%.

Mr. Eric E. Breisach
July 6, 1994
Page 2

As shown in the accompanying charts, we've also tracked PaineWebber's estimate of the market expectations for cable stocks over the past thirty months. For our purposes this is used to determine when cable stocks were under or over valued relative to other securities. The inputs vary based on estimates as to ten year cash flow growth, which declined dramatically after the FCC rate regs, and the current capital structure, estimated tax rates and projected "terminal market" multiples for each of the four major publicly traded companies, Time Warner, Tele-Communications Inc., Comcast and Cablevision Systems. Although such analysis is, perforce, sensitive to estimate changes and individual inputs, the charts suggest that prior to April 1993 and the first FCC ruling, investors typically looked for equity returns above 20% in the larger and therefore less risky publicly traded cable equities.

Today, the decline in cash flow growth expected to materialize during the next several months has driven down expected estimated equity returns to between 14% and 18%, well below that experienced by investors in the past.

Thus, our analysis suggests that on both a theoretical basis and from market performance, investors in the industry have come to expect equity returns above 20% for most of the cable industry's history. We therefore would conclude that rate of return regulation that does not compensate equity investors at or above those levels will make it difficult for system operators to attract equity capital. So, too, as the data we've tracked deals exclusively with the larger lower risk entities, we would expect smaller systems to have even more difficulty attracting capital, unless equity returns are well above 20%.

Sincerely,

Christopher Dixon

CPD/tl
Attachment

DISCOUNTED CASH FLOW VALUATION

Christopher Dixon 212-713-2420

Example

Company ABC	25.0	Assumptions	
Shares out	20.0	Terminal multiple	8
Market Equity	500.0	Growth rate	10%
Debt	500.0	Interest cost	10%
Cash	(100.0)	Tax rate	34%
Off balance sheet	(100.0)	W/C reinvest	5%
Total enterprise value	800.0		
Forward Cash flow	100.0	Debt to capital	50%
CF Multiple	8	IRR	24%

Proforma cash income statement

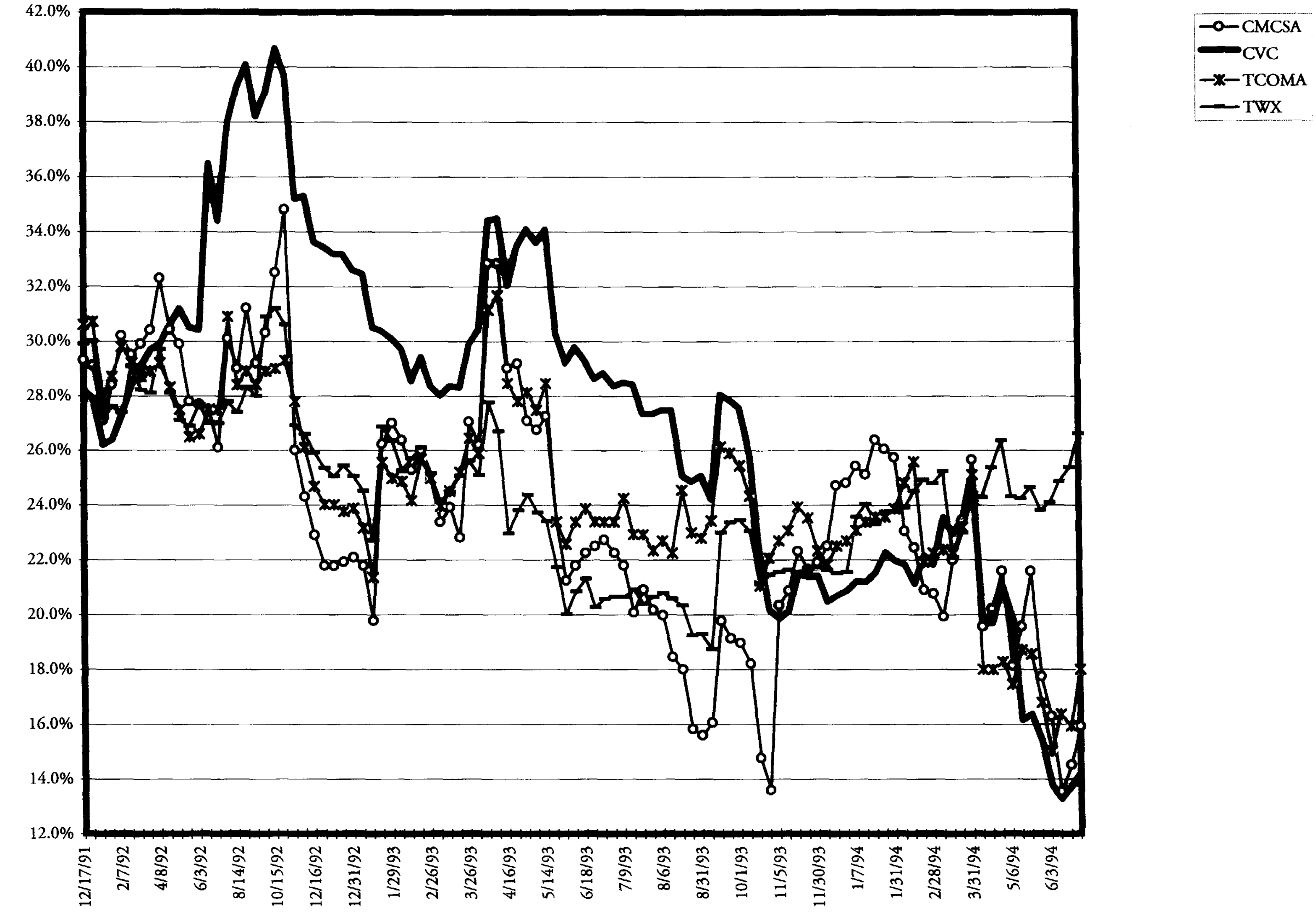
Period	1	2	3	4	5	6	7
Cash flow	100.0	110.0	121.0	133.1	146.4	161.1	177.2
Interest expense	(50.0)	(50.0)	(50.0)	(50.0)	(50.0)	(50.0)	(50.0)
Pre tax	50.0	60.0	71.0	83.1	96.4	111.1	127.2
Cash taxes	(17.0)	(20.4)	(24.1)	(28.3)	(32.8)	(37.8)	(43.2)
Net income	33.0	39.6	46.9	54.8	63.6	73.3	83.9
WC reinvest	(1.7)	(2.0)	(2.3)	(2.7)	(3.2)	(3.7)	(4.2)
Terminal multiple							8.0
TEV							1,417.2
Debt							(500.0)
Cash/Off balance sheet							200.0
Terminal value of Equity							1,117.2
Available to Equity	31.4	37.6	44.5	52.1	60.4	69.6	1,197.0
Investment	(500.0)						
Cash flows	(468.7)	37.6	44.5	52.1	60.4	69.6	1,197.0
IRR	**24%**						

note key assumptions

1) Depreciation = capital expenditures, therefore tax may be too high

2) Debt stays at same level through period

Theoretical return on equity

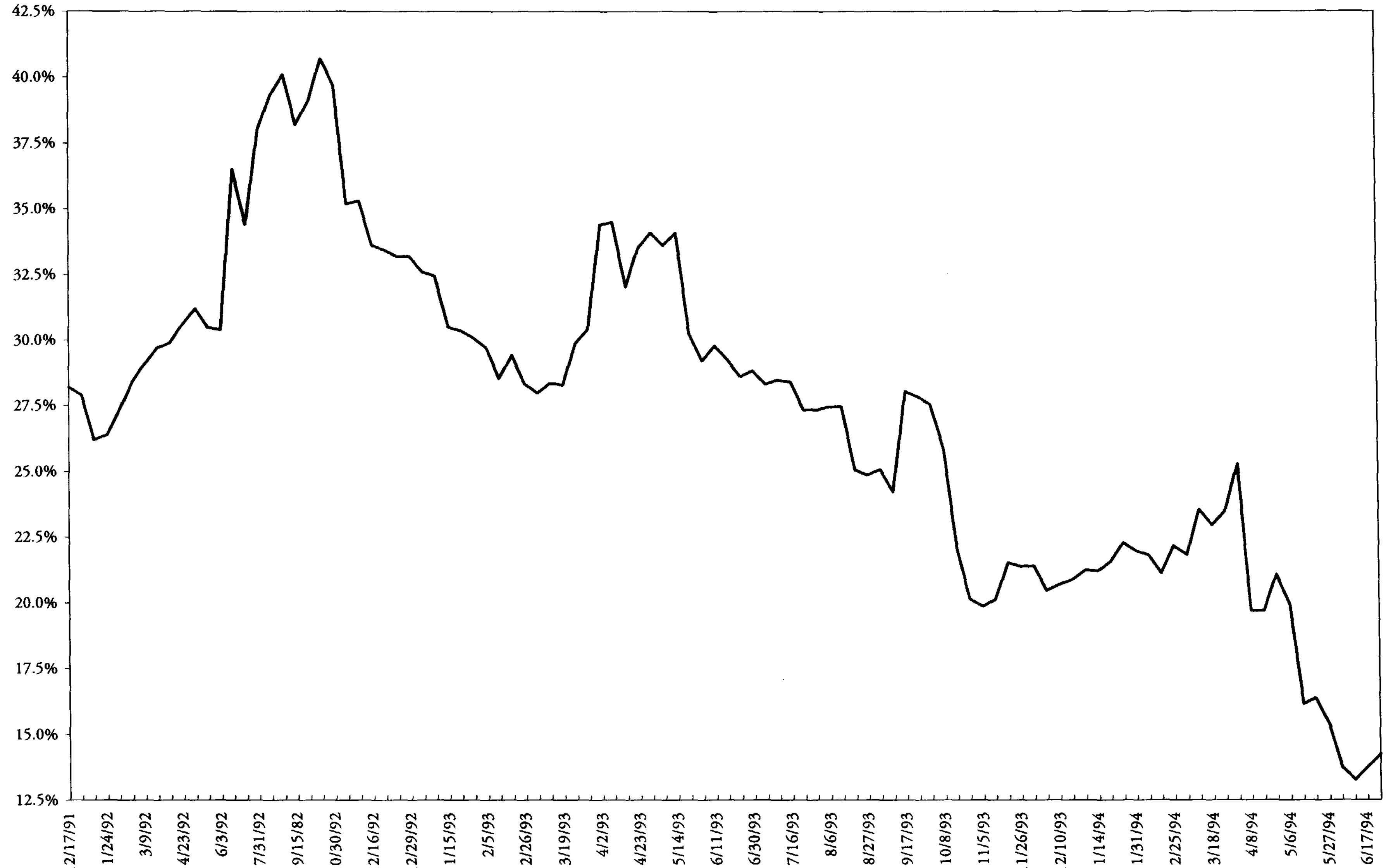


Source: PaineWebber Inc. estimates

CMCSA theoretical return on equity

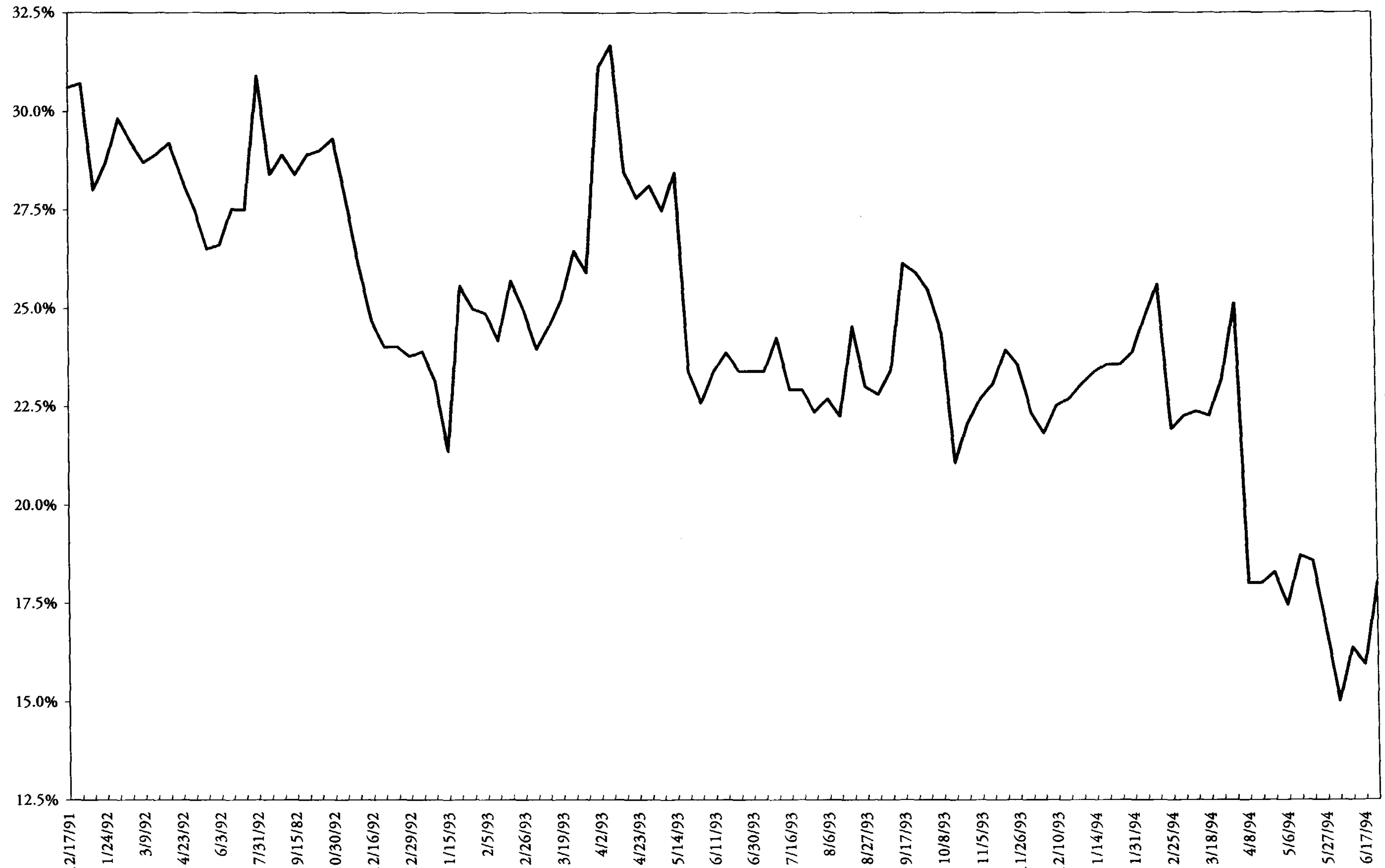
Source: PaineWebber Inc. estimates

CVC theoretical return on equity



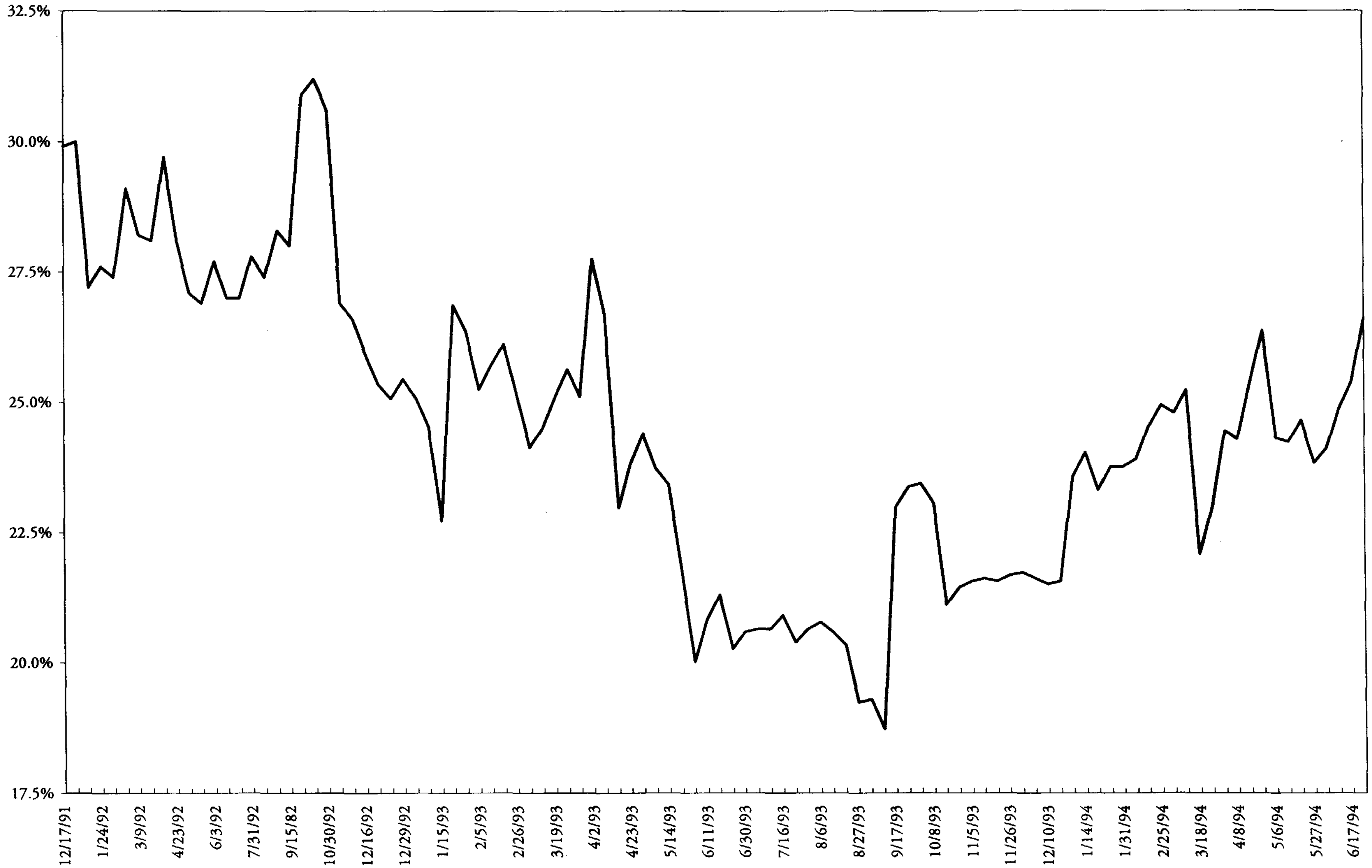
Source: PaineWebber Inc. estimates

TCOMA theoretical return on equity



Source: PaineWebber Inc. estimates

TWX theoretical return on equity



Source: PaineWebber Inc. estimates

Cost of Equity
Summary

REPRESENTATIVE COSTS OF EQUITY
Small Cable Business Association
Exhibit to Cost-Of-Service Reply Comments

Operator	Cost of Equity	Notes
Communications Equity Assoc.	28%	Note 1
Daniels & Associates	25% - 30%	Note 2
Pioneer Cable, Inc.	20% - 30%	Note 3
Rigel Communications	35%	Note 4
Sun Country Cable	25% - 30%	Note 5

Communications Equity Associates is a major venture capital firm serving the cable television industry. The cost of capital listed is based on their experience serving the cable television industry.

Daniels & Associates is a firm specializing in locating financing for the cable televiison industry. The ranges listed are based on its extensive experience in locating equity capital.

The rates of return were based on attempts in prior years by Pioneer to attract capital. Pioneer now believes that equity capital is no longer available to smaller operators following the implementation of regulation. Pioneer cable serves 3,500 subscribers.

Rigel serves approximately 2,500 subscribers.

The range is based on actual experience of building 31 cable systems since 1987. The 25% return is demanded by private investment trusts while the 30% amount by venture capital firms. Sun Country currently serves 9,600 subscribers.

Cost of Equity
Support

COMMUNICATIONS EQUITY ASSOCIATES

06-29-1994 RCVD

June 27, 1994

THIS IS THE ORIGINAL OF A LETTER FAXED TO YOU TODAY.

Mr. Eric Breisach
Small Cable Business Associates
c/o: Kinley Simpson
7901 Stoneridge Drive
Suite 404
Pleasanton, California 94588

Dear Eric:

As you may know, Communications Equity Associates, Inc. ("CEA") has been assisting small cable television operators in raising equity and senior debt for the last 21 years.

Because of the 1992 Cable Act, banks and venture capitalists have taken a very conservative view of the future of cable television. I would say that there are only approximately 10 or 12 venture capitalists that would consider lending funds to the cable television industry, in general. Very few of them would consider lending to a small cable television operator. The rate of return which they demand is around 28% annually over a period of five or six years.

Generally, banks are no longer lending to the small cable operator unless the loan is at least $10 million, so today it is really impossible for a small operator to receive any senior debt.

With the demand to keep up with new technology, expand system plant and ever-increasing programming expenses, operating margins continue to decline for the small operator. Thus, a rate of return of 11.25% is no incentive whatsoever for an operator to even remain in the business.

Should anyone have any questions on this subject, please feel free to give me a call.

Sincerely,

Jay

W. Jay Dugan, Jr.
Senior Vice President

WJDjr/lt

101 East Kennedy Boulevard, Suite 3300 • Tampa, Florida 33602 • (813) 222-8844 • FAX (813) 225-1513

DANIELS & ASSOCIATES

Pat Thompson
VICE PRESIDENT/DIRECTOR
SMALL SYSTEMS BROKERAGE

July 1, 1994

Mr. Eric Breisach
Howard & Howard
107 West Michigan Avenue
Kalamazoo, MI 49007

RE: FCC Docket MM 93-215

Dear Eric:

In regard to the rulemaking in the above docket of the FCC, the following applies:

> It has been my experience in dealing with small system sales for the last 17 years that equity participants expect to see returns of at least 25% and in many cases north of 30%. These percentages are based on returns annualized over a five year period. Interest rates charged by lenders to small operators are typically at least 300 basis points over prime, whereas most of the larger MSO's can borrow at prime or 150 basis points over at the highest.

Sincerely,

DANIELS & ASSOCIATES

Pat Thompson

Pat Thompson

PT/ss

Denver Headquarters:
3200 Cherry Creek South Drive
Suite 500
Denver, Colorado 80209
Telephone 303 778-5555
Telecopy 303 778-5599

New York Office:
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New York, New York 10171
Telephone 212 935-5900
Telecopy 212 832-2784

A General Partnership

Pioneer Cable, Inc.

183 Washington • P.O. Box 39, Monument, CO 80132 • 481-2451

RECEIVED
JUN - 6 1994

July 1, 1994

Eric Breisach
Howard & Howard
107 W. Michigan Avenue
Kalamazoo MI 49007

FAX: (616)382-1568

Dear Eric:

Several years ago I vigorously explored sources of equity funding for small cable systems. Investment bankers (Boettcher & Co. and Rotan-Mosley) structured limited partnerships that would have returned 20 percent--but were unable to attract investors.

I also talked with two established venture capital sources--who required returns on investment in the 20-30 percent range. (Since the imposition of the FCC's new regulations, it is unlikely that any venture capital is available to small operators even at 30 percent ROI.)

In 1986 I arranged $750,000 financing (for the acquisition and buildout of two small systems) at 50 basis points above prime rate. In 1989 we borrowed an additional $1 million to buy another system; the rate was adjusted to 75 basis points above prime. Soon thereafter, our lender, Citizens Fidelity Bank & Trust of Louisville, Kentucky, quit making cable loans. Their experience with cable borrowers was excellent but new federal banking regulations had classified all cable loans as "highly leveraged transactions." They no longer wanted anything to do with cable.

In 1993, we had to seek re-financing in order to upgrade and extend our plant. Fortunately, we found one bank that would loan us the $1.7 million needed to pay off Citizens Fidelity and a subordinated note. But the interest rate is 300 basis points (3%) above the prime lending rate.

Obviously, lenders and investors regard a small cable business as a risky, speculative venture--not at all similar, for example, to a utility. The premium they require is presumably based on the developing competition from other video providers, the threat of overbuild by telco giants, and government regulation which raises costs while limiting rates.

Since small cable businesses do not have access to the public equity market, we are dependent on banks and private investment. The traditional bank sources won't entertain a loan of less than $10 million and those that will make "small" loans charge rates of 10% ±. If inflation should return to the average rate experienced over the past 20 years, we will be paying 12 percent and more.

Small cable companies are even more capital intensive than large systems because of typically much lower density and higher costs per subscriber. Consequently, the proposed 11.25 percent rate of return is wholly unrealistic and could prove fatal to companies serving many hundreds of communities.

Sincerely,

Stan Searle

Stanley M. Searle
President

SMS:cas

RIGEL

June 29, 1994

Mr. Eric Breisach
HOWARD & HOWARD
The Kalamazoo Building
Suite 400
107 West Michigan Avenue
Kalamazoo, MI 49107

Dear Eric:

I would like to give you some examples of interest rates and equity returns for use in your comments for the FCC's rule making on cost of service:

In order to begin my cable business in 1986, I offered the following equity return: cumulative preferred dividend return of 25% (deferred), plus a 35% interest in the company. At payout the investors would expect at least a 35% annual return on their investment.

Rigel's first commercial loan called for 8% current interest and 16% deferred compounded monthly. The company also paid owners of acquired cable systems 9% to 12.5% interest annually on their subordinated debt.

Please feel free to call if you have any questions.

Sincerely,

Doug

Douglas J. Feltman
President

DJF:gy

RIGEL COMMUNICATIONS INC., 70 LEACH HOLLOW ROAD, SHERMAN, CT 06784
(212) 886-3321 (203) 354-9945

Sun Country Cable
7901 Stoneridge Drive #404 Pleasanton, CA 94588
Phone 510-463-1919 Fax 510-463-9827

June 27, 1994

Mr. Eric E. Breisach
Howard & Howard
107 W. Michigan Avenue
Kalamazoo, MI 49007

Re: FCC Docket MM 93-215

Dear Eric:

This letter is in connection with comments to be filed by the Small Cable Business Association in the rulemaking in the above docket of the Federal Communications Commission regarding the proposed rate of return of 11.25% for cable television operators. Based on my experience in obtaining equity financing for the purchase or construction of 31 cable systems since 1987, the rate of return proposed by the FCC is wholly inadequate to attract equity financing for small cable operators.

In my experience, outside equity investors in small cable operations are either guaranteed or expect to receive returns in the range of 25-30% compounded annually. The high end of that range is the expectation of those venture capital firms or funds still willing to invest in cable; the low end, for private investment trusts.

Sincerely,

David D. Kinley

David D. Kinley
President

SUMMIT COMMUNICATIONS, INC. SC

James A. Hirshfield, Jr.
President

June 30, 1994

RECEIVED
JUN - 6 1994

Mr. Eric E. Breisach
Howard and Howard
107 West Michigan Ave.
Kalamazoo, MI 49007

RE: FCC Docket MM 93-215

Dear Eric:

You have asked for input regarding specific equity returns required by outside investors in privately owned cable TV systems. These opinions were formed during my 28 years in the cable TV business, and particularly during the decade of the 80's when I formed and financed four limited partnerships to build five and acquire 3 cable TV systems. From 1974 to 1976 I served as Vice President and Controller of Seafirst Bank, a $8 billion Washington State bank.

It is my experience that private investors look for an internal rate of return of 15% to 20% above Prime interest rate, and seek time horizons of five to seven years. Such investors understand that their investment will be illiquid until the cable system is refinanced, and thus look to both a limited horizon and a higher rate of return as compensation. They have little flexibility with which to deal with unforeseen risks during the period of illiquidity. They tend to rate investing in a privately owned cable company as similar to investing in any other start-up or "initial phase" company. That is, they see lower certainty that such projects will even break-even, let alone generate significant return, and thus demand compensation for these risks.

Debt poses similar problems. Cable lending banks wish to make investments above a certain minimum size. Bankers dealing with smaller size loans simply do not understand the cable business. Thus it is very difficult to obtain debt from banks at levels below $5 million. Small borrowers are driven to alternate financers, who typically charge Prime plus 4 - 6%, and may demand kickers and restrictive indentures as well.

Sincerely,

3633 136th Place S.E. Suite 107 Bellevue, WA 98006 206-747-4600